



Memorandum

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Jacky Morales-Ferrand

SUBJECT: "MISSING MIDDLE" HOUSING

DATE: May 17, 2019

Approved

Date

5/17/19

BACKGROUND

In the Mayor's March 2019 Budget Message, the City Manager was directed to identify \$10 million of Inclusionary Program fee revenue to provide an investment in "missing middle" housing. This expenditure to create a "missing middle" housing fund potentially aligns with Governor Newsom's January Proposed Budget calling for an investment of \$500 million for the development of housing for creation of the Missing Middle housing through the establishment of California Housing Finance Agency's (CalHFA) Mixed-Income Loan Program. The City Manager was further directed to return during the budget process with a cost estimate for the creation of a "missing middle" affordable housing fund leveraging private investment, including costs associated with legal fees, structuring, planning, and execution.

ANALYSIS

With prior direction from the Mayor's Housing Crisis Workplan, the Housing Department has already been exploring innovative financing approaches to support new housing development for the "missing middle," including the potential creation of a private-public investment fund for this purpose.

The Housing Department engaged consulting help from David Rosen and Associates (DRA) in 2018 to analyze the creation of private-public investment fund for the "missing middle." DRA's analysis¹ has focused on how to incent market-rate housing production in San José to include a small percentage of moderately-priced restricted affordable apartments. The consultant's assumptions for development costs, types of buildings, and submarket rents are consistent with those presented in late 2018 to the City Council in the Cost of Residential Development. DRA's financial and market analysis indicates that the use of reasonable-cost mezzanine financing with lower rates than typically found in the financing market could potentially incent moderate-income units to be created by developers who use private financing sources. A mezzanine loan

¹ David Rosen & Associates, *Moderate-income Housing Fund for San José revised findings*, Jan. 17, 2019.

provides additional debt needed to construct a development. It is repaid in second to what is usually a conventional loan from a commercial lender. Because its repayment is less certain than the senior loan, it generally carries higher interest rates than do senior loans. The mezzanine loans would be in second position behind short-term conventional construction financing. The mezzanine loans would be designed to be repaid by longer-term permanent financing after buildings are built and economically stabilized. However, at this time, no source of take out funds has been identified as potential forward-commitments of permanent financing. Staff has concluded that if a fund could be created and capitalized with private investors' funds to provide reasonable-cost mezzanine financing for projects with a certain percentage of affordable moderate-income units, then additional affordable moderate-income units might be built.

The intention is that the City's role, if any, would be limited to set-up and potentially advisory during operations, and would not include providing capital for development. Research to date has not revealed any California cities that have directly created and run this type of investor-financed fund; therefore, it is likely that a separate organization would need to be established to create and run the fund.

Further analysis on the feasibility and structure of a potential fund is ongoing. The purpose of additional analysis is to evaluate the viability of such a fund by further gauging feasibility and potential investor interest, and by determining potential roles that the City would play, if any. If Inclusionary Program fee revenue is used to fund the set-up of such a fund, the units must be restricted affordable for at least 55 years for households at or below 120% of Area Median Income (AMI), priced no higher than 110% AMI, in keeping with the purpose of the Inclusionary Program. However, the Department recommends using General Fund as the funding source for the initial start-up costs, since this is still an early phase of research and there's no guarantee about units that will be built, what income levels they will be at, and whether the City could enforce affordability restrictions if it did not contribute capital to the fund.

The near-term efforts contemplated include:

Activity	2019-2020 General Fund Cost Estimate
<p><i>Prospectus Abstract & Draft Term Sheet</i></p> <p>Develop materials to support further research and meetings with potential investors and advisors on development of a potential mezzanine debt fund for new construction of moderate-income rental housing fund in San José ("Fund"). Develop a brief draft Fund prospectus ("Abstract"), consistent with a completed financial and market analysis. This Abstract may also include a draft Term Sheet for the mezzanine debt product that could be offered by the Fund. Also, develop an estimate for the drafting of a full fund prospectus compliant with securities regulations, likely through outside counsel who specializes in securities regulations. Housing Department staff time for review, edits, meetings, and finalization is included.</p>	\$11,000

<i>Obtain Additional Consultants with Specialized Expertise</i> Seek outside legal counsel who specializes in securities regulations and financial experts with specialized experience in municipal establishment of investment funds. These consultants will review the draft Fund prospectus to ensure that the establishment of such a fund complies with securities regulation and other applicable laws, is viable and is appropriately structured.	\$100,000
<i>Business Plan & Financial Model</i> Draft a brief Business Plan which outlines how the Fund will be created and managed to support further research and meetings. With support of the additional consultants, prepare a financial model for the Fund's operations, projected income and expenses, and development pipeline associated with Fund project financings. Housing Department staff and DRA will work with Planning, Building and Code Enforcement to identify projects in the permitting stage likely to start construction within the next three years. Staff will combine this pipeline analysis with interviews of developers whose projects are capable of starting construction within three years. This will provide important information to any prospective fund manager.	\$18,500
<i>Market Research</i> Continued research and discussion with pension funds (CalPERS, STRS), and insurance funds (COIN) officials and executives, as well as other State executives, regarding their interest in providing take out financing for Fund project loans which have achieved completion of construction, lease up, stabilized occupancy and conversion to permanent financing. These discussions will be conducted with managers at CalPERS, STRS, and COIN. Housing Department staff time for meetings and research on other City-involved funds, research memos, and potential Council memo is included.	\$13,500
TOTAL	\$143,000

If approved, the Housing Department will continue to work with DRA to achieve these tasks using DRA's existing contract. The outcome of these preliminary efforts will be presented to Council to seek further direction on how to proceed and any future costs related to this work would be presented at that time.

COORDINATION

This memorandum was coordinated with the City Manager's Budget Office, the Finance Department and the City Attorney's Office.

/s/
JACKY MORALES-FERRAND
DIRECTOR